In the Supreme Court of the United States

OCTOBER TERM, 1970

CALLAHAN MINING CORPORATION & SUBSIDIARY,
PINNACLE EXPLORATION, INC., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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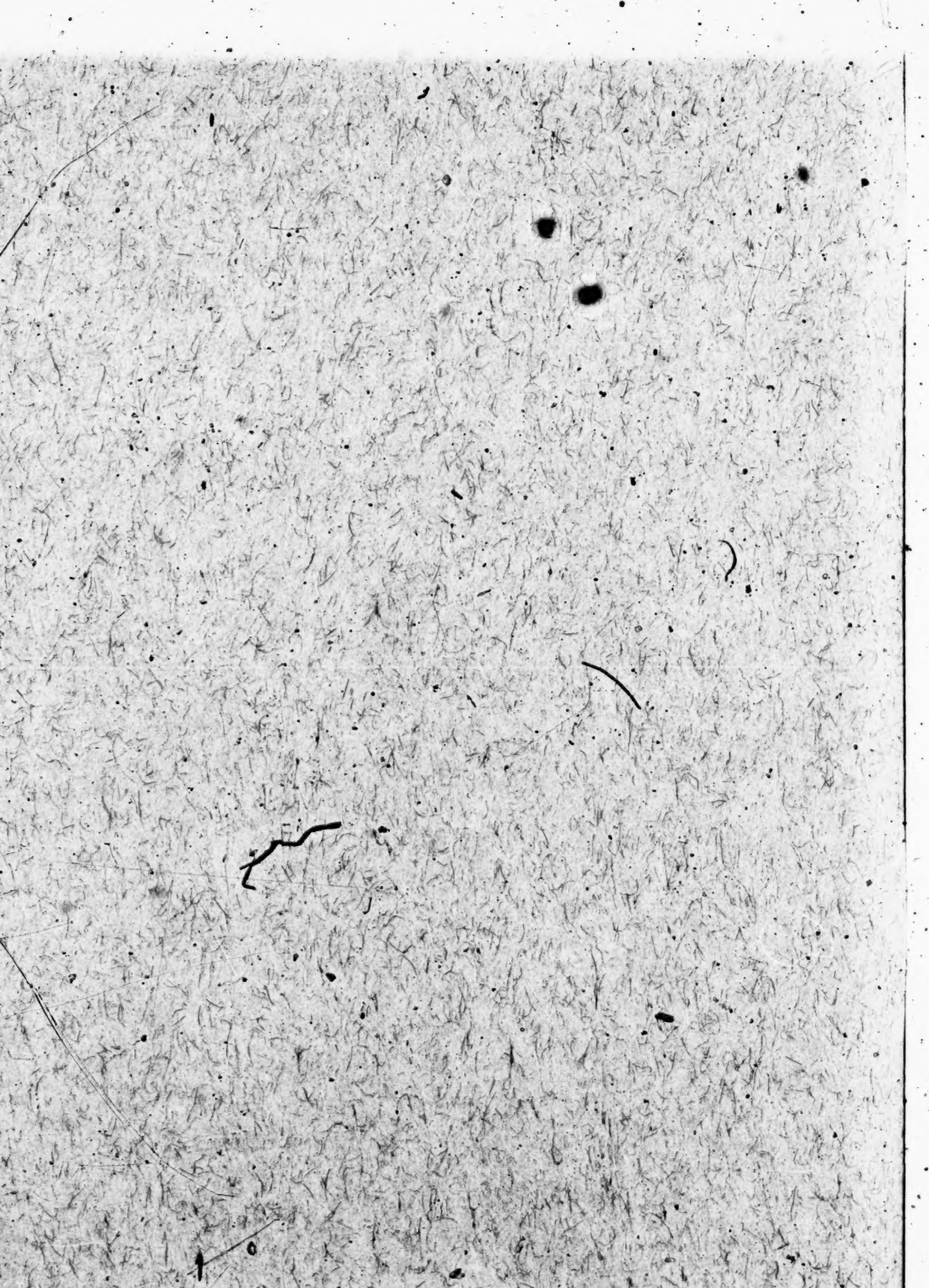

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OPINIONS BELOW AND JURISDICTION

The opinions below and the basis for this Court's jurisdiction are adequately set forth in the petition.

QUESTION PRESENTED

Whether petitioners are entitled to include in their depletion base only the amount of net profits actually received under the terms of a lease and not, as they contend, 50 percent of gross production income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are set forth in the Appendix to the petition (pp. 41a-46a).

STATEMENT

This income tax case involves the equitable apportionment of the percentage depletion deduction between Callahan Mining Corporation and its subsidiary (petitioners) and their lessee for the taxable years 1959, 1960 and 1961. Petitioners owned mining property in Northern Idaho. In January, 1947, petitioners, through a wholly owned subsidiary, leased the property to American Smelting and Refining Company (ASARCO) under an agreement which granted ASARCO the exclusive right to explore, develop and operate the mining property for 30 years with an option to renew for an additional 30 years. ASARCO was to advance all necessary funds. Initially, the net profits from the operation of the mining property were to be used to reimburse ASARCO for such expenditures and to establish and maintain a working capital account of $500,000. During the initial period, petitioners were to receive 50 cents per ton of ore mined. Thereafter, petitioners were to receive 50 percent of the net profits or 50 cents per ton of ore mined, whichever was greater. (Pet. App. 15a-28a.)

Since 1947, ASARCO has operated the mining property. During the initial period of operation, which ended in early 1959, petitioners received 50 cents per ton of ore mined. (Pet. App. 28a-29a.)

ASARCO's unreimbursed expenditures for the operation of the mining property reached $3,641,079 by December 31, 1954. After that date, the operation became profitable and reimbursements to ASARCO began. (Pet. App. 29a.)

By January, 1959, sufficient net profits had been generated from the operation of the mining property to reimburse ASARCO for all its prior expenditures, including amounts paid by it to petitioners, and to establish a working capital account of $500,000. While this working capital account was being established in 1958 and 1959, petitioners continued to receive payments of 50 cents per ton of ore mined, which payments were deducted in determining net profits. Since the establishment of the working capital account in 1959 and during all years in issue, petitioners and ASARCO have divided net profits equally. (Pet. App. 29a.)

Petitioners received net profit payments from ASARCO pursuant to the agreement during 1959, 1960 and 1961. In 1959, petitioners also received payments from ASARCO under the agreement based on 50 cents per ton of ore mined. (Pet. App. 30a.)

On their federal income tax returns for 1959, 1960 and 1961, petitioners computed and claimed percentage depletion deductions on the mining property based on gross income from sales reduced by amounts applied to working capital and capital expenditures (Pet. App. 31a). Both the Tax Court (Pet. App. 14a-43a) and the court of appeals (Pet. App. 4a-13a) upheld the Commissioner's determina-

tion that petitioners should compute their depletion deduction based on the amounts actually received from ASARCO as net profits during the years in issue.

ARGUMENT

The decision below turns on the language of a written agreement providing for net profit payments to the lessor of mining property. The decision is correct. There is no conflict of decisions or any other basis for further review by this Court.

1. Section 611(a) of the Internal Revenue Code of 1954 authorizes, in computing taxable income from mining, a deduction for "a reasonable allowance for depletion." Under Section 613(a) of the Code, the allowance is "the percentage, specified in subsection (b), of the gross income from the property excluding * * * rents or royalties paid or incurred by the taxpayer in respect of the property." Section 613(c)(1) provides that "gross income from the property", when the property is not an oil or gas well, is "gross income from mining." Section 611(b)(1) provides that, in the case of a lease, the deduction "shall be equitably apportioned between the lessor and lessee." An equitable apportionment is obtained by excluding from the lessee's gross income from the property an amount equal to any rent or royalties paid or incurred by the lessee in respect of the property. Such deductions are part of the gross income of the lessor. *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 604.

A taxpayer holds a depletable economic interest to the extent that he has acquired by investment an interest in minerals in place and secures, by any form

of legal relationship, income derived from extraction to which he must look for a return of his investment. *Palmer* v. *Bender*, 287 U.S. 551. The depletable economic interest continues so long as the taxpayer looks solely to the mineral, if, as, and when produced, for a return of his capital. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 26; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312. Retention of ownership or any other particular form of legal interest in the mineral content of the land is not required. *Palmer* v. *Bender*, *supra*, p. 557; *Kirby Petroleum Co.* v. *Commissioner*, *supra*, p. 603.

An economic interest may be a percentage of gross production (*i.e.*, a royalty), a production payment in a fixed amount, or a percentage of the net profits—separately or in combinations—provided that they are dependent solely on production. The type of economic interest determines to whom income derived from production is taxable and to whom a deduction for depletion is allowable. *Burnet* v. *Harmel*, 287 U.S. 103; *Palmer* v. *Bender*, *supra*; *Thomas* v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404; *Kirby Petroleum Co.* v. *Commissioner*, *supra*; and *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*. The holder of an economic interest is entitled to depletion only to the extent of the portion of production accruing to his interest. *Kirby Petroleum Co.* v. *Commissioner*, *supra*; *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*.

Here, the court below correctly held that petitioners' economic interest in the mining property was a non-operating interest limited to the net profits payments

actually received. Under the terms of the lease agreement, ASARCO had sole control of, and was obligated to advance all capital necessary for, the development and continued operation of the mining property. Petitioners were not liable for any part of those expenditures, and ASARCO could look only to net profits for reimbursement. The record amply supports the Tax Court's conclusion and the court of appeals' affirmance that, under the circumstances, the existence of the $500,000 working capital account did not affect the economic realities of the agreement (Pet. App. 12a-13a, 36a-37a).

Petitioners' contention that a holder of a net profits interest constructively receives—and may deplete—the portion of gross production income which, devoted to development and production expenses, produces the net payments actually received has uniformly been rejected. The operator alone has the burden of the development and production expenses which he must meet, if he can, out of gross production income. The risk of loss is solely his. This being the case, the gross production income (less the net profits payments and any payments to holders of royalties or production payments) is the operator's depletable income. These results flow from the contractual rights and obligations of the parties, established at the outset of the venture. The courts are not "at liberty to construct a theoretical gross income" for a net profits participant "by recourse to the expenses of production operations." *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 382.

In *Helvering* v. *Mountain Producers Corp.*, *supra*, the taxpayer was an oil lessee who agreed to sell all of the oil produced to a refining company which, as part of the price, agreed to do the drilling and conduct all production operations. This Court held that the taxpayer's depletable gross income from the property was limited to the cash received, rejecting the taxpayer's contention that it should include the refining company's expenses of development and operation (p. 382):

> The term "gross income from the property" means gross income from the oil and gas * * * and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted "gross income" of the taxpayer within the meaning of the statute. * * * *We do not think that we are at liberty to construct a theoretical gross income by recourse to the expenses of production operations.* The Refining Company for its own purposes undertook the expenses of those operations, and * * * [the taxpayer] was content to receive as its own return the cash payments for the oil produced, leaving to the Refining Company the risks of production. [Emphasis supplied.]

Petitioners suggest (Pet. 8) that the "logic of *Mountain Producers* compels the conclusion that lessors of mining property and similar property, whose interests are measured by *net* profits, are entitled to de-

pletion based not only on the share of profits distributed to them in cash but also on that portion of gross income used to pay the expenses which diminish that share of profits." This suggestion has no support in *Mountain Producers* and, in fact, was specifically rejected in that case. The decision below is in accord with *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9), ceritorari denied, 379 U.S. 819; *Grandview Mines* v. *Commissioner*, 282 F. 2d 700 (C.A. 9); *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276 (C.A. 9) (which cites and quotes from *Mountain Producers Corp.*); *Farwell* v. *Commissioner*, 35 T.C. 454; and *McLean* v. *Commissioner*, 41 B.T.A. 565, affirmed on other issues, 120 F. 2d 942 (C.A. 5), certiorari denied, 314 U.S. 670.

2. None of the authorities cited by petitioners conflicts with the holding below. *Reynolds* v. *McMurray*, 60 F. 2d 843 (C.A. 10), certiorari denied, 287 U.S. 664, was based, as was *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5), on the premise that income from mineral property is to be taxed to the holder of legal title. *McMurray* preceded and is incompatible with this Court's initial formulation of the economic interest concept in *Palmer* v. *Bender*, *supra*, and has been criticized and disapproved by the Ninth Circuit in *United States* v. *Thomas*, *supra*. *Abercrombie* has been overruled by the Fifth Circuit in *United States* v. *Cocke*, 399 F. 2d 433, certiorari denied, 394 U.S. 922. In *Cocke*, the Fifth Circuit, consistently with the decision below, held that a taxpayer not liable for development and operational expenses was not entitled to depletion on such sums.

Finally, *Handelman* v. *United States*, 357 F. 2d 694 (Ct. Cl.), also relied on by petitioners, involved local taxes paid by a mineral lessee where under local law the lessor was the primary obligor. In this case, on the other hand, petitioners were not liable for any part of the development or operational expenditures. Moreover, the court below, in accord with *Handelman*, allowed petitioners depletion on their share of the state tax.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1970.